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IN THE

Supreme Court of the United States

OCTOBER TERM, 1940.

No. 466.

DONALD N. GILBERT *et al.*,
Petitioners,
against
THE PEORIA AND EASTERN RAILWAY COMPANY *et al.*,
Respondents.

No. 467.

WILLIAM CARNEGIE EWEN *et al.*,
Petitioners,
against
THE PEORIA AND EASTERN RAILWAY COMPANY *et al.*,
Respondents.

BRIEF OF RESPONDENT, THE PEORIA AND EASTERN RAILWAY COMPANY, IN OPPOSITION TO PETITIONS FOR WRIT OF CERTIORARI, AND REPLY TO MOTIONS FOR DIMINUTION OF RECORD.

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Preliminary Statement.

The proceedings below were had pursuant to Chapter XV of the Bankruptcy Act (Sections 700-755) for an ad-

justment of debt of The Peoria and Eastern Railway Company, herein called the Peoria and Eastern. That Chapter invests the Court with jurisdiction in respect of "postponements or modifications of debt, interest, rent, and maturities or for modifications of the securities or capital structures of railroads" (Sec. 700). Abundant safeguards for the protection of the rights of all concerned, including such security holders as the present petitioners, have been provided by the statute and were observed in this case. Before the proceeding may be instituted in Court, the Interstate Commerce Commission must authorize the issuance or modification of securities contemplated by the plan of adjustment. The Commission is specifically required to "scrutinize the facts independently of the extent of acceptances of such plan and of any lack of opposition thereto" and approval may only be granted on the basis of specific findings by the Commission that the adjustment, among other things, is in the public interest and the best interests of each class of creditors and stockholders, is feasible and financially advisable (Sec. 710). Following hearing and extensive evidence, the Commission rendered its unanimous Report and Order of approval (Exhibit 30). Thereafter, not less than the required two-thirds in amount of the affected security holders having assented to the Plan, proceedings for approval and authorization were had before a Special Court composed of Circuit Judge Learned Hand and District Judges John M. Woolsey and Murray Hulbert. As in the proceeding before the Commission, so also in the court proceeding, the statute makes meticulous provision for safeguarding the rights of all security holders. Here, also, specific findings by the three-judge Court are required as a condition to approval of the

Plan (Sec. 725). After full hearings and a complete record (more than three-fourths in amount of the affected security holders having assented), the Court made its detailed findings and entered its enabling decree. In the only other instances where review of cases under this Chapter of the Bankruptcy Act has been sought, petitions for certiorari have been denied. (*Getz* v. *Baltimore & Ohio R. Co.*—Certiorari denied January 29, 1940, 309 U. S. 654; Re-hearing denied March 25, 1940, *ibid.* 697. *Steelman* v. *Wichita Falls & S. R. Co.*—Certiorari denied April 22, 1940, 309 U. S. 687; Re-hearing denied May 20, 1940, 84 L. Ed. 906.) The statute was temporary in nature and expired, except as to proceedings previously initiated, on July 31, 1940 (Sec. 755). There is, therefore, no suggestion that the disposition of this proceeding will affect other contemporaneous or prospective cases.

Although we feel constrained to discuss the questions raised by petitioners, it is submitted that none of the questions so presented, nor the case itself, is of a character warranting review by the Supreme Court.

Historical Background.

The Peoria and Eastern is an Illinois corporation which, pursuant to a Reorganization Agreement, acquired from the purchasers in foreclosure proceedings, by deed dated February 22, 1890, that part of the former Ohio, Indiana and Western Railway extending from Pekin, Illinois, to Indianapolis, Indiana, a distance of 201.53 miles, the part from Pekin to the Illinois-Indiana boundary line (conveyed in fee) being called therein the Illinois part and the part from the Illinois-Indiana line to Indianapolis (leased in perpetuity) being called therein the Indiana part. The

deed was made subject to two underlying mortgages securing prior bonds, viz.: (1) $1,000,000 of 7% Indiana, Bloomington and Western Railway Company Bonds, herein called I. B. & W. Bonds, due January 1, 1900, which were subsequently extended to April 1, 1940 with interest at 4% per annum, and (2) $500,000 of 5% Ohio, Indiana and Western Railway Company Preferred Bonds, herein called O. I. & W. Bonds, due April 1, 1938 (Findings 1, 3, 5 and 7).

That part of the former Ohio, Indiana and Western Railway extending from Indianapolis, Indiana, to Springfield, Ohio, called the Springfield Division, was conveyed by the purchasers in the foreclosure proceedings, by deed dated February 22, 1890, to The Cleveland, Cincinnati, Chicago and St. Louis Railway Company, herein called the Big Four, reserving a Purchase Money Lien thereon for $5,000,000 which, if not previously paid, was to become enforceable by foreclosure or otherwise on April 1, 1940. The Big Four was not obligated to pay the principal but was obligated to pay as interest the net earnings of the property up to 4% per annum upon said $5,000,000 (Finding 6).

Pursuant to said Reorganization Agreement, the Peoria and Eastern also executed its Consolidated Mortgage dated February 22, 1890, to secure $10,000,000 of its 4% Consolidated Bonds due April 1, 1940, of which $7,930,000 were to be issued at that time and $1,500,000 were reserved for issue in exchange for the prior lien bonds. The mortgage covered the Peoria and Eastern Railway, subject to the prior lien bonds, and there was pledged thereunder the $5,000,000 Purchase Money Lien on the Springfield Division (Finding 8).

Pursuant to said Reorganization Agreement, the Peoria and Eastern also executed its Income Mortgage

dated February 22, 1890, securing $4,000,000 of its Income Bonds due April 1, 1990, bearing interest at a rate not in excess of 4% per annum, but payable only out of the net earnings and income of the property as provided in the mortgage (p. 27, this brief). The mortgage covered the same property as the Consolidated Mortgage, subject to the prior lien bonds and the Consolidated Bonds, and was subject to the Operating Agreement and Supplement thereto hereinafter referred to (Finding 11).

Also, pursuant to the Reorganization Agreement, an Operating Agreement, dated February 22, 1890, was entered into between the Peoria and Eastern and the Big Four. In view of the fact that the principal contentions of petitioners, interveners below, are predicated on misapprehension of the Operating Agreement, a statement of its provisions is here given:

> First*—The Peoria and Eastern grants to the Big Four, subject to the mortgages securing the Consolidated Bonds, the right to use and operate the Illinois part and assigns its leasehold interest in the Indiana part of the Peoria and Eastern Railway, together with its rolling stock and equipment (to be considered as included in the Indiana part) and the Big Four agrees during a period of fifty years from April 1, 1890 *and for such further time thereafter as it may elect,* to use and operate said Railway providing at its expense all other rolling stock and equipment, labor and supplies necessary for that purpose and in general complying with all obligations upon the Peoria and Eastern with respect to its maintenance and operation.
>
> Second—The Big Four covenants to make good any deficiency which may at any time occur in the

* Paragraph references are to the articles of the Operating Agreement (Exhibit 26).

fund necessary for the due and punctual payment as it accrues of the interest on the two series of prior bonds (I. B. & W. Bonds and O. I. & W. Bonds) and of the interest on the Consolidated Bonds, after devoting to such interest payment the net income from the Purchase Money Lien of $5,000,000 on the Springfield Division and the net earnings derived from the Indiana part and the net earnings derived from the Illinois part of the Railway and the Big Four guarantees that the net earnings and income from said three sources *so actually applied to the payment of interest* should not be less than $412,200* in each and every year of the fifty years for which it undertook the use and occupation of said Railway, such guarantee to be increased in the sum of $40 for each $1,000 of Consolidated Bonds issued in excess of $9,430,000, and with the authority to the Peoria and Eastern to assign the covenants contained in such second clause to the Trustees of the mortgage securing the Consolidated Bonds, and then such covenants were to be deemed a direct guarantee by the Big Four of the payment of interest on said bonds and on said prior mortgage bonds.

Third—The Big Four was to receive all earnings and income from the use and operation of the Railway and of the rolling stock and equipment and was to apply the net earnings of each year arising from the same "(to be ascertained by deducting from the earnings and income of the year from its use and operation of said 'Illlinois part' and said 'Indiana part', the expenses of operation and maintenance during such

*7% interest on $1,000,000 I. B. & W. Bonds, 5% interest on $500,000 O. I. & W. Bonds and 4% interest on the then outstanding $7,930,000 of Consolidated Bonds equal $412,200. At time of extension, in 1900, of the I. B. & W. Bonds, the interest rate was reduced to 4%, and ever since that time the figure of $412,200 has had only historical interest (Finding 5(a)).

year, including taxes, assessments, insurance, rental and other like charges, and the cost of repairs, renewals and reasonable betterments to the said 'Illinois part' and the said 'Indiana part', necessary for their economical and efficient operation)", together with the net income from the Purchase Money Lien on the Springfield Division, to the payment of the interest upon the two series of prior bonds (I. B. & W. Bonds and O. I. & W. Bonds) and to the payment of interest upon the Consolidated Bonds. After reimbursing itself out of what should remain of such net earnings and income not applied to the payment of interest for any advances under the agreement in any previous year remaining unpaid to it (with interest at 6% per annum), the Big Four was to apply the balance of said net earnings and income to the payment of interest on the Income Bonds according to the requirements of the mortgage securing such bonds and pay over to the Peoria and Eastern any amount remaining. The Big Four was to be entitled to make the customary charge for the use of any and all additional rolling stock and equipment furnished by it as theretofore provided for use on said lines of railroad, such charge to be included in the expense of operation.

Fourth—The Big Four was, within sixty days after December 31, 1890 and each year thereafter, to render an account to the Peoria and Eastern of its operations under the agreement and also was to render proper accounts to the Trustees under the Income Mortgage.

Fifth—The Big Four was to look only to such future net earnings of said lines of railroad operated by it under the Operating Agreement and such future income of such Purchase Money Lien as should not be required for the payment of interest on the prior bonds and on the Consolidated Bonds for the reimbursement to it of any sums it might advance in compliance with

its aforesaid agreements, and the Peoria and Eastern charged all such future net earnings and income not required for the payment of such interest with the payment of all such advances to the Big Four with interest at 6%.

Sixth—The Peoria and Eastern was to permit the Big Four to use its name in the operation of said railroad.

Seventh—Upon default, the Peoria and Eastern might resume operation without affecting the interest guaranty by the Big Four. All property acquired through earnings of the Peoria and Eastern was to become its property, and upon termination of the contract the Big Four was to restore to the Peoria and Eastern appropriate rolling stock and equipment at least equal in value to the rolling stock and equipment received.

By the Supplement to the Operating Agreement of even date therewith, all sums paid out by the Big Four for interest over and above the net earnings as defined in Article Third of the Operating Agreement and net income from the Purchase Money Lien were to be deemed advances by the Big Four under Article Fifth of the Operating Agreement against all parties save the Consolidated Bondholders and the Trustees under the mortgage securing such bonds (Exhibit 27).

Plan of Adjustment.

At the time of the preparation of the Plan of Adjustment dated January 10, 1940, the Peoria and Eastern faced the maturity on April 1, 1940, of the following outstanding securities (Finding 31):

$846,000, principal amount, of I. B. & W. Bonds outstanding in the hands of the public (exclusive of $154,000, principal amount, of such bonds held in a sinking fund for such bonds);

$8,376,000, principal amount, of Consolidated Bonds in the hands of the public (exclusive of $124,000, principal amount, of such bonds held in the sinking fund for the I. B. & W. Bonds); and

$500,000, principal amount, of indebtedness incurred to provide for the payment of the O. I. & W. Bonds on April 1, 1938, evidenced by note of the Peoria and Eastern in that amount secured by $500,000, principal amount, of Consolidated Bonds and by 1730 shares of stock of the Peoria and Pekin Union Railway Company of the par value of $173,000.

In addition to the above maturities:

The term of the Operating Agreement would expire on April 1, 1940, unless extended.

The $5,000,000 Purchase Money Lien on the Springfield Division would become enforceable on April 1, 1940.

The charter of the Peoria and Eastern would expire, unless extended, on February 20, 1940, and to effect an extension under the Illinois statute, in addition to a three-fourths stock vote, the stockholders desiring renewal were required to agree to purchase at its current value the stock of those opposed.

In aid of the proposed Plan of Adjustment, the Big Four agreed to vote its holdings of stock in favor of the extension of the charter of the Peoria and Eastern and to make the required agreement to purchase the stock of opposing stockholders and, subject to the Plan becoming effective, to pay the Purchase Money Lien on the Springfield Division.

The Plan provides that:

Out of the $5,000,000 so to be paid by the Big Four:

$846,000 is to be applied to payment in full of the prior I. B. & W. Bonds;

$384,500 is to be applied on account of the Consolidated Bonds pledged for the indebtedness of $500,000 incurred in connection with the payment of the O. I. & W. Bonds on April 1, 1938, and The Securities Corporation of the New York Central Railroad is to accept such payment and $115,500 of reduced principal amount of such Consolidated Bonds (to be extended for twenty years with interest at 4%) in satisfaction of the indebtedness and is to surrender the stock of the Peoria and Pekin Union Railway Company of the par value of $173,000 pledged as security;

$3,769,200 is to be paid ratably on account of the principal of the remaining $8,376,000, principal amount, of outstanding Consolidated Bonds, being at the rate of $450 for each $1,000 Bond, and the reduced principal amount is to be extended for twenty years with interest at 4%;

$300 is to be used by the Trustee in the purchase of the reduced and extended Consolidated Bonds.

The Operating Agreement is to be extended for an additional term of twenty years, carrying with it the obligation upon the Big Four during such extended term to operate the property, to assure the costs of maintenance and operation, taxes and reasonable betterments and to pay the interest on the Consolidated Bonds (the prior bonds being paid).

The 1730 shares of stock of the Peoria and Pekin Union Railway Company, having a par value of $173,000, are to be pledged as additional security under the mortgage securing the Consolidated Bonds, and the $154,000 of I. B. & W. Bonds and $124,000 of Consoli-

dated Bonds held in the sinking fund for the I. B. & W. Bonds are to be surrendered.

The advances made by the Big Four and New York Central under the Operating Agreement are to continue their existing status under such agreement.

The Income Mortgage Bonds are to continue their existing status.

The moneys held by the New York Central for the Peoria and Eastern in an equipment retirement account and future accretions to such account are to be applied currently in the acquisition of equipment.

Proceedings in Special Court.

Gilbert et al., petitioners in No. 466, intervened in the Court below, alleging that they had constituted themselves as a Committee of Consolidated Bondholders and that they represented holdings which aggregated about 6% of the outstanding issue of said Consolidated Bonds.

Ewen et al., petitioners in No. 467, also intervened in the Court below, upon an allegation that they represented holdings of Income Bonds aggregating approximately 7½% of the outstanding issue of said Income Bonds.

The contentions now made by petitioners were urged before the three-judge Court but were overruled as indicated in the opinion that was filed and in the findings and decree that approved the Plan, with a slight modification not here material.

Comments on Certain Statements in the Petitions.

Before passing to a discussion of the reasons advanced by petitioners in support of their applications, it is appropriate to comment on certain matters referred to on pages

8-15 of the petition of the Gilbert Committee and on pages 3-9 of the petition of the Ewen Committee.

(1) Gilbert Committee brief.

The valuation shown at page 8 is the valuation of the Commission for rate-making purposes. The book value is greater. Such valuation, however, shows total assets of $12,337,133 against fixed interest mortgage bonds outstanding after consummation of the Plan of $4,722,300. Other indebtedness amounts to $6,485,482. This leaves, on such basis, a value in excess of $1,000,000 for the capital stock.

At page 9 there is reference to the fact that during the ten years ending with 1939 (assuming the Purchase Money Lien to have been paid) the average annual earnings would have amounted only to $170,301 per year, while the interest on the Consolidated Bonds, after the consummation of the Plan, will amount to $188,892. These have been years of great depression in the railroad industry and as far as the Consolidated Bondholders are concerned the interest on such bonds will, under the Plan, be guaranteed by the Big Four or New York Central, lessee, for the next twenty years.

At page 10 the comment relates to the instrumentality rule. The Reorganization Agreement of the Ohio, Indiana and Western Railway in 1889 followed protracted negotiations between the O. I. & W. Reorganization Committee and a Committee of the Big Four (Exhibits K to Q, and S), and the issue of one-half of the capital stock of the Peoria and Eastern to the Big Four was in consideration of the various agreements made by the Big Four in connection with that reorganization. These exhibits clearly indicate that the 1889 Reorganization Agreement was negotiated by per-

sons dealing at arm's length and negative any suggestion of domination by the Big Four in the formulation of the Operating Agreement, the Consolidated Mortgage, the Income Mortgage and the other instruments by which such reorganization was accomplished and the rights of the parties concerned in the present Plan of Adjustment are defined.

Under the instrumentality rule any contract between a controlling and controlled company is, of course, subject to careful scrutiny. Such rule, however, does not mean that an agreement which is fair and of advantage to the controlled company is to be condemned merely because of such control. The proposed Plan of Adjustment and the extension of the Operating Agreement were approved by the affirmative vote of 73,694 shares of stock of the Peoria and Eastern, with only 20 shares voting in opposition (Exhibit 4).

The so-called "accumulation of operating deficits" commented upon (p. 10) are made up of $1,806,493 for additions and betterments made to the Peoria and Eastern property, $105,667 for retiring prior I. B. & W. Bonds, $54,651 for the purchase of 480 shares of stock of the Peoria and Pekin Union Railway Company, and the balance for certain miscellaneous items and accrued interest (Exhibit I). The matter of the divisions of rates was considered by the Interstate Commerce Commission. No suggestion has been made that the divisions are not fair or do not accord with the usual arrangement. The implication in the statement that the Big Four reduced its charges in 1919 from $324,286 to $24,912 is a caricature of the facts. Exhibit V sets forth the settlement then made. The reversal of charges claimed in Exhibit Y is made up for the most part of re-audits of

freight accounts made by the Peoria and Eastern auditor (Exhibit X). Such accounts are subject to re-audit between railroads continuously as more detailed information regarding shipments becomes available. The accounts of the Peoria and Eastern are subject at all times to the supervision of the Commission.

In addition, the Income Mortgage (Article Sixth) provides for filing each year of full accounts and for inspection of the books by an officer of the corporate trustee or by an expert accountant whose services are required to be paid for by the Peoria and Eastern. Such accounts have been filed regularly each year (Exhibit 51).

During the period from 1920 to 1930 railroads generally required substantial expenditures for betterments to enable them to operate with heavier power. This meant the laying of heavier rail, the strengthening of bridges, and signal and other changes necessary in connection therewith. Exhibit 36 which covers the period 1923-1939 shows that the account was largely made up of such items. This cost was advanced by the Big Four and, to the extent not repaid, is reflected in the present account. The Consolidated Mortgage by reason of such expenditures is now a lien upon a modern railroad plant.

Comment is made, at pages 11-15, on the equipment account, the status of equipment under the Consolidated Mortgage and alleged diversion of the mortgage estate.

Under the Operating Agreement the rolling stock and equipment of the Peoria and Eastern were included as part of the Indiana part. Articles First and Third of said agreement provided for the maintenance, renewal and replacement of the existing equipment and the furnishing by the Big Four, at the usual *per diem* charges, of all additional

equipment required in excess of the Peoria and Eastern's owned equipment; and Article Seventh of said agreement provided for the turning over at the termination of said agreement of equipment of equal value to that received.

Under the regulations of the Commission, in order that each year may properly reflect the expenses of such year, there is charged upon the books of railroad companies against the revenues of that year a sufficient percentage of the original cost of equipment to aggregate, at the expiration of its assumed life, such cost. Under the regulations of the Commission, when equipment is retired, the cost thereof is charged against the depreciation account; and in the present case, in order to show the amount of equipment retired and not replaced, such amount is transferred from the depreciation account to a retirement account and, as equipment is replaced, the cost of the replacement is charged against the retirement account. The retirement account of the Peoria and Eastern thus represents the original cost of equipment retired and not replaced, while the depreciation account represents the aggregate of the annual book charges against operating revenues on account of the loss of service life of equipment still in existence (Minutes, p. 209).

The Big Four does not, under the Operating Agreement, owe the Peoria and Eastern at this time the amounts in the depreciation account and retirement account, but it is obligated to keep up the equipment and at the termination of the agreement to turn over to the Peoria and Eastern equipment of a value equal to that of the equipment received. The suggestion in the Gilbert brief, that the Consolidated Bondholders may be entitled to cash in that amount, only

emphasizes the confusion of counsel in their consideration of the proposed Plan. They seem to have in mind a salvage operation, with no regard to the other security holders, the public, or the contractual situation.

Reference is made at page 13 to the release clause of the Consolidated Mortgage (Paragraph Eighth), which provides that the Trustees may require the deposit of the *proceeds of sale* of property released to be applied in like manner as is provided in respect of proceeds of insurance. Equipment retired is equipment that has become worn out and the service life of which has ended. It is not equipment sold and released.

In passing, it may be said that since the amount shown in the equipment retirement and equipment depreciation accounts represent charges against the operating revenues of the Peoria and Eastern in accordance with the regulations of the Commission, interest at the rate of 6% per annum on said amount is credited currently against the interest on the advances made by the Big Four or New York Central to the Peoria and Eastern under the Operating Agreement.

(2) Ewen Committee brief.

At page 3 the statement is made that the Reorganization Agreement of 1889 was formulated by and under the supervision of the Big Four. Not only does the record fail to support this assertion but, on the contrary, the undisputed evidence definitely negatives the assertion (Exhibits K to Q).

At pages 4 and 5 certain provisions of the Operating Agreement are stated. Such statement does not give an

accurate picture of its terms (as is shown at pages 5-8 of this brief).

At page 5 reference is made to a statement made in February, 1890, by the then President of the Big Four. His generalization does not affect the terms of the agreements actually executed. The sum of $412,200, to which he refers as "net rental", represented the interest on the then outstanding fixed interest bonds as shown above (p. 6).

At page 7 there is the statement that the decision of the Commission approving the applications "was predicated upon the assumption, and so recorded in the decision," that there was no opposition to the Plan of Adjustment and to the renewal of the Operating Agreement. The Commission in its report (Exhibit 29), said:

> "We have scrutinized the facts relative to this application independently of the extent of the acceptance of such plan by the bondholders, and of the lack of any opposition thereto, and conclude that on the record here before us the authorization sought should be granted."

At page 10 reference is made to the Special Court being "influenced in its decision by the threats of the New York Central". There were no such threats. The Court could hardly have passed upon the Plan without taking account of the probable consequences of its rejection.

Reasons Advanced in Gilbert Committee Brief (pp. 19, 20) Do Not Warrant Allowance of Writ.

1.* The *Los Angeles Lumber Company* case (308 U. S. 106) and the *United States Realty and Improvement Company* case (310 U. S. 434) are not applicable to an adjustment such as is here under consideration, because here:

(a) The corporation has been found not to be in need of financial reorganization under Section 77 and its inability to meet its debts matured or about to mature has been found to be temporary only (Findings 44, 45);

(b) The corporation is not insolvent (pages 8 and 9 of Gilbert petition), and the total assets on the basis there shown are more than two and a half times the amount of Consolidated Bonds which will be outstanding if the Plan be consummated, and more than $1,000,000 in excess of the claims of all creditors;

(c) A payment of $450 is made on account of the principal of each $1,000 of Consolidated Bonds and the bonds prior in lien thereto are paid in full;

(d) The stockholders consent to the pledge, as additional security under the Consolidated Mortgage, of shares of stock owned by the Corporation and now unpledged having substantial value and approve the surrender of $154,000 of prior lien bonds and $124,000 of Consolidated Bonds held in the sinking fund for such prior lien bonds;

(e) The majority stockholder under the extension of the Operating Agreement guarantees the payment of maintenance and operating expenses, reasonable betterments and taxes as well as the interest on the reduced principal of the Consolidated Bonds during the extended term of twenty years;

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* Paragraph numbers refer to those shown in Gilbert brief, pp. 19, 20.

(f) There is no scaling down of the claims of creditors and the rights of stockholders continue junior and subordinate to the rights of creditors.

2. Similarly, the *Louisville Trust Company* case (174 U. S. 674) is not applicable to this adjustment. The position of the Consolidated Bonds is strengthened and the payment of interest thereon and of cost of reasonable betterments to the property is assured even though the revenues may at times be less than maintenance and operating expenses, taxes and interest. The rights of the other creditors remain unaffected by the Plan. The record does not show any inequitable conduct.

3. The provisions of Chapter XV of the Bankruptcy Act show it is not a mere moratorium statute, but that it is intended to authorize an adjustment such as has been here provided for. The requirement of Section 710(2)(b), that there must be a finding that the corporation's *inability* to meet its debts is reasonably expected to be temporary only, cannot rationally be construed as a requirement that any *postponement* of maturities under the Plan must be temporary only. The term "adjustment" as defined in Section 705(7) expressly includes a modification of maturities, of securities or capital structures. Section 710(2) requires the order of the Commission under Section 20a of the Interstate Commerce Act "authorizing the issuance or modification of securities as proposed by such plan of adjustment." Section 735 of the Act makes inapplicable certain sections of the Internal Revenue Code "to the issuance, transfer, or exchange of securities or the making or delivery of conveyances to make effective any plan of adjustment confirmed under the provisions of this chapter", and also provides

that no taxable income, gain or profit is to be deemed to have accrued or to be realized by such petitioner "by reason of a modification of or cancelation in whole or in part of any of the indebtedness of the petitioner affected by a proceeding under this chapter".

4. The only creditors affected by the Plan of Adjustment under the definition contained in Section 706 are the Consolidated Bondholders.

The Reorganization Agreement of the Ohio, Indiana and Western Railway (Exhibit S), in accordance with which a 50% stock control of the Peoria and Eastern by the Big Four was acquired in 1890, shows its main purpose to have been the security of the Consolidated Bonds. Such Bonds were to represent, under the exchange provided for, all the First Mortgage Bonds, most of the accrued interest thereon and one-half of the Second Mortgage Bonds of the former company (subject to the prior lien bonds of $1,500,000). The Income Bonds were under the plan to represent the other $1,000,000 of Second Mortgage Bonds, certain accrued interest and about $2,500,000 of the Preferred Stock of the former company. The execution of what is here called the Operating Agreement was also provided for therein, giving assurance not only of the payment of interest, operating and maintenance expenses and taxes, but reasonable betterments as well, and the agreement was one of the conditions pursuant to which both the Consolidated and Income Bonds were issued.

Judicial notice may probably be taken of the fact that during the 1920s most railroads were required to make substantial betterments to permit of the use of heavier power, requiring heavier rail, the strengthening of bridges and

other like changes. Over $1,800,000 of the advances now owing by the Peoria and Eastern to the Big Four or New York Central were made for these purposes (Exhibit I). The Gilbert petition now claims that the Big Four should forego the repayment of the advances made by it pursuant to its covenants under the Operating Agreement and which has provided a modern railroad plant, because of the control which was transferred to the Big Four upon the formation of the Peoria and Eastern as part consideration for the agreements so made. The Operating Agreement provided for its continuance at the election of the Big Four, which elected to extend it. No reason can be suggested, based on the instrumentality rule, under which the Big Four should under such circumstances waive its rights as a creditor. The Plan does not determine the amount of advances made by the Big Four but leaves the parties in this regard unaffected by the Plan.

5. There is no basis for the statement that the Court assumed that there was no alternative between approving the Plan and ordering a strict foreclosure. As a matter of fact the Special Court did prescribe a minor modification, saying in its opinion, "Hence we will modify the plan by virtue of the power given us in Sec. 721 so as to provide that the income bondholders shall have one director upon the board" (See also Finding 51). A plan which for its consummation depends upon the payment by a third party, in this case the Big Four, of the $5,000,000 Purchase Money Lien, which it was not obligated to pay, and the extension of the term of the Operating Agreement with guaranty of the interest on the reduced principal amount of the Consolidated Bonds, which the Big Four was not

obligated to extend or guarantee, does not lend itself to major modifications, without consent of such third party.

With respect to the reference to subdivision (h) of the Assignment of Errors: The Commission's valuation of the Peoria and Eastern property plus additional assets is, as above stated, about two and a half times the principal of the Consolidated Bonds to be extended. The argument that there should be a sinking fund for retirement of the Bonds seems to be grounded, as far as any question of law is involved, upon the claim that an extension of a maturity by a plan under Chapter XV must be a temporary extension only, though the statute does not so provide. It is argued that twenty years is not a temporary extension but can be made so by a sinking fund provision to retire part of the bonds prior to the extended maturity date. In other words, it seems that a twenty-year extension is temporary, or not, according to the amount of bonds affected thereby. The Income Mortgage permits of an extension of the Consolidated Bonds. It does not permit of new charges upon income such as a sinking fund.

With respect to the reference to subdivision (i) of the Assignment of Errors: Under the Plan the equipment as it is replaced will become subject to the lien of the mortgage securing the Consolidated Bonds. The depreciation account represents loss of service life of equipment already in existence and, with the retirement account, affords an accounting measure of the equipment which the Big Four would need to turn over to the Peoria and Eastern in fulfillment of its covenant in Article Seventh of the Operating Agreement, were the Operating Agreement immediately to terminate. The retirement account does not represent an amount now due. The Consolidated Bondholders are en-

titled to a lien upon the equipment as replaced. They have no claim upon the account which represents merely the loss of service life of the existing equipment and which account, at the termination of the Operating Agreement, may be greater or less than at present, dependent upon the amount of equipment meanwhile turned over to the Peoria and Eastern.

6. Where the special three-judge Court itself hears and weighs the evidence and makes the findings, we submit that such findings have at least as great weight as where made by the Court upon review of a special master's findings.

Reasons Advanced in Ewen Committee Brief (Points A to F, pp. 16-29) Do Not Warrant Allowance of Writ.

A:* The extension of the Operating Agreement was a matter primarily between the Big Four and the Peoria and Eastern and was approved by an overwhelming vote of the stockholders of the Peoria and Eastern at a meeting called for that purpose with only 20 shares opposing (Exhibit 4). The extension was approved and authorized by the Interstate Commerce Commission under Paragraph (4) of Section 5 of the Interstate Commerce Act (Exhibit 30). The effect of such an order of the Commission has been considered in the following, among other, cases: *Venner* v. *Michigan Central Railroad Company,* 271 U. S. 127; *Lambert Run Coal Co.* v. *B. & O. R. R. Co.,* 258 U. S. 377, and *Illinois Central Railroad Co.* v. *State Public Utilities Commission,* 245 U. S. 493. The authorization and

* Paragraph letters refer to those shown in Ewen brief, pp. 16-29.

approval of the Court were not necessary to the validity of the extension agreement. The guaranty of interest on the Consolidated Bonds and of payment of maintenance and operating expenses, taxes and reasonable betterments to the property was, however, necessarily a part of the Plan were it to be approved by the Consolidated Bondholders. This being so, and the right of the Big Four to elect to extend the Operating Agreement having been challenged, the Special Court had to pass upon that question incident to its consideration of the Plan. Indeed, the extension of the Operating Agreement, with the guaranties therein contained, was obviously vital and necessary to any plan of adjustment.

B: The Ewen brief charges (1) that the Special Court erred in construing the Operating Agreement as authorizing the extension of the term thereof at the election of the Big Four and New York Central and (2) that the Income Bondholders are adversely affected by such extension.

On the first point the main reliance is on the case of *Western Transportation Co.* v. *Lansing* (1872), 49 N. Y. 499. This case was correctly distinguished and held inapplicable, in view of the different circumstances, by the Special Court in its opinion holding that the Big Four had the right at its election prior to the expiration of the term of the Operating Agreement to make the extension. The following decisions in the States where the road is located tend to support the decision of the Special Court: *Anderson* v. *Dodsworth*, 292 Ill. 335; *Falley* v. *Giles*, 29 Ind. 114; and *Hughes* v. *Windpfennig*, 10 Ind. App. 122.

Under the opinion in the *Western Transportation Case*, it is clear that a lease may provide for an extension of the

term at the election of the lessee for a period to be fixed by him, provided the duration of the extension is to be fixed by the lessee at or before the commencement of the extended term. In that case the Court held that the extension provision of the lease there involved did not require the lessee so to fix the term but allowed him to continue on at will after the expiration of the original term and that the provision was, therefore, bad for uncertainty as to duration of the term.

This case was commented upon in *Hoff* v. *Royal Metal Furniture Company,* 117 A. D. 884, affirmed without opinion in 189 N. Y. 555, where the Court had under consideration a covenant for a perpetual yearly renewal of lease, and Gaynor, J., said:

> "The case of *Western Transportation Co.* v. *Lansing* (49 N. Y. 499) is not in point. There the covenant was held to be non-enforceable for uncertainty in respect of the term, and also because the landlord had died. I suppose it is proper to say that the opinion is discursive and has to be read with discrimination. The exact point decided is all that serves as a precedent."

Exhibits 2 and 49 show that the Big Four elected to extend the Agreement for twenty years prior to the expiration of the term. The Income Mortgage was expressly subject to the provisions of the Operating Agreement.

In any event, aside from the right of the Big Four to extend the Operating Agreement, the Income Bondholders are not adversely affected by such extension. The Ewen contention that the Big Four would lose the right to look to future net earnings of the Peoria and Eastern for reimbursement of its advances in the event that the Operating

Agreement were now to terminate is not sustained by the controlling instruments. The wording of Article Fifth of the Operating Agreement, that the Big Four shall look only to the "future net earnings of said lines of railroad operated by it under these presents * * *" for reimbursement of its advances, merely identifies the property to whose future earnings the Big Four may look for its reimbursement. This view is supported by the provision of the Supplement to the Operating Agreement and the provisions of Articles Sixth (p. 27, *infra*) and Fifth of the Income Mortgage and is the fair and reasonable interpretation having regard to the fact that the Operating Agreement is not a lease but an agency contract whereby the Big Four without profit undertook to operate the Peoria and Eastern for account of that company under the terms of the Operating Agreement. To hold that termination of the Operating Agreement automatically effects a forfeiture of advances made for account of the Peoria and Eastern not only involves a strained construction of the words but produces a most inequitable result. The point, however, need not be labored in view of the contractual right to extend the Operating Agreement.

C: The terms of the Operating Agreement are summarized, *supra* (pp. 5-8). The reference in Point C is to Article First under which the Big Four agrees to comply with the obligations of the Peoria and Eastern with respect to the operation and maintenance of the railway. The provisions for meeting expenses and for distribution of the earnings are in Articles Second and Third, and when the three articles are read together it is clear that the construction argued for is untenable. The provision of the Income

Mortgage, relating to the payment of interest, is in Section Sixth, the first paragraph of which is as follows:

> "SIXTH.—That beginning with the year ending December 31, 1890, the Board of Directors of the Railway Company shall ascertain and declare the net earnings and income applicable to the payment of interest upon the bonds secured hereby for the year ending the 31st day of December in each year, by deducting from the gross earnings and income of the Railway Company for such year all interest on prior bonds, and on said First Consolidated Mortgage Bonds, expenses of operation and maintenance, taxes, assessments, insurance, rentals and other like charges, cost of repairs, renewals and reasonable betterments to the property of the Railway Company necessary for its economical and efficient operation, and all deficiencies arising from payments for said purposes in former years not otherwise provided for, and all advances which shall have been made to provide for such deficiencies or any part of them, and shall apply such net earnings and income (or such portion thereof as may be necessary) towards payment of the interest on the bonds hereby secured, in accordance with their terms and the provisions hereof."

The Ewen argument under C is based not only upon a disregard of the provisions of the Operating Agreement but of the provisions of the Income Mortgage as well. The statement made by the President of the Big Four to his Directors some time in 1890 was a mere informal generalization of the total obligation of the Big Four in respect of the prior bonds and Consolidated Bonds. It did not modify the terms of the executed instruments. The guaranty contained in the Operating Agreement and the refer-

ence to the proposed guaranty contained in the agreement with the Reorganization Committee had only to do with the interest on the prior lien bonds and the Consolidated Bonds, which, as shown above, amounted to the sum of $412,200 at the time of the execution of the Operating Agreement.

D: The proceeds of the Purchase Money Lien under the provisions of the Plan are to be applied to the payment of bonds to which the Income Bonds were by the Income Mortgage made expressly subject. The extension of the date of maturity of the Consolidated Bonds was also expressly permitted by the Income Mortgage. No consent or permission was necessary under the Income Mortgage for such application, and such application could have been made with the consent of *all* the Consolidated Bondholders without a Plan. Chapter XV permits such application upon the approval of 75%, instead of all, of the Consolidated Bondholders. In either case the Income Bondholders are not affected. The formula pursuant to which interest becomes payable upon the Income Bonds was not changed by the extension of the Operating Agreement.

E: The statement that the Plan is not fair and equitable as an adjustment is based mainly on the *Los Angeles Lumber Co.* case, which, as discussed above, has no relevancy to the present case. The requirement that a plan be "fair and equitable" does not mean that it may disregard the rights of the various classes of security holders under the instruments defining their respective rights. In the present case the stockholders are making a real contribution to the Plan and their rights remain subordinate to those of the

bondholders. Any question regarding the annual accounting to the Peoria and Eastern and to the Trustees under the Income Mortgage would appear safeguarded by the provision in the Income Mortgage under which, at the request of the Trustee or of the holders of one-fifth of the Income Bonds, the accounts may be subjected to an examination by an expert accountant selected by the Trustee and paid for by the Peoria and Eastern.

F: There were no threats by the New York Central or the Big Four. The Big Four was not obligated to pay the Purchase Money Lien of $5,000,000 upon the Springfield Division, unless it elected to do so. Finding 23 shows that practically 74% of the overhead traffic of the Peoria and Eastern, which overhead traffic constitutes more than 50% of its total traffic, comes to the Peoria and Eastern from the New York Central. The effect of disrupting the existing relationship was patent to the Interstate Commerce Commission and to the Court.

Conclusion.

Wherefore, we respectfully submit that the petitions for writ of certiorari should be denied.

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